Supreme Court, U.S.
FILED
NOV 12 1996
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No. 96-569

In The

Supreme Court of the United States

October Term, 1996

PERRY S. McKAY,

Petitioner,

v.

CHRISTINE J. JOBIN, Chapter 7 Trustee of the Bankruptcy Estate of M & L Business Machine Co., Inc.,

Respondent.

On Petition For Writ Of Certiorari
To The United States Court Of Appeals
For The Tenth Circuit

BRIEF IN OPPOSITION

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QUESTIONS PRESENTED FOR REVIEW

1. Whether, in defense of a claim brought by a bankruptcy trustee under § 548(a)(1) of the Bankruptcy Code, a transferee who is an investor in a Ponzi scheme, will be found to lack good faith if the circumstances would place a reasonable person on notice of the debtor's fraudulent purpose, and a diligent inquiry would have discovered the fraudulent purpose.

2. Whether the ordinary course of business defense set forth in § 547(c)(2) of the Bankruptcy Code is available to an investor in a Ponzi scheme when the investor fails to present sufficient evidence to meet the requirements to such defense.

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The opinion of the United States Court of Appeals for the Tenth Circuit is reported at 84 F.3d 1330 (Pet. App. 69). The opinion of the United States District Court for the District of Colorado is reported at 164 B.R. 657 (Pet. App. 46). The opinion of the United States Bankruptcy Court concerning the parties' cross motions for summary judgment is reported at 155 B.R. 531 (Pet. App. 1). The Bankruptcy Court's June 10, 1993 opinion following trial was unreported (Pet. App. 25).

STATUTES INVOLVED IN THE CASE

A. 11 U.S.C. § 547(c)(2):

(c) The trustee may not avoid under this section [11 U.S.C. § 547(b)] a transfer –

* * *

(2) to the extent that such transfer was –

(A) in payment of a debt incurred by the debtor in the ordinary course of business or financial affairs of the debtor and the transferee;

(B) made in the ordinary course of business or financial affairs of the debtor and the transferee; and

(C) made according to ordinary business terms[.]

B. 11 U.S.C. § 548(a)(1):

(a) The trustee may avoid any transfer of an interest of the debtor in property, or any obligation incurred by the debtor, that was made or incurred on or within one

year before the date of the filing of the petition, if the debtor voluntarily or involuntarily –

> (1) made such transfer or incurred such obligation with actual intent to hinder, delay, or defraud any entity to which the debtor was or became, on or after the date that such transfer was made or such obligation was incurred, indebted[.]

C. 11 U.S.C. § 548(c):

Except to the extent that a transfer or obligation voidable under this section [11 U.S.C. § 548] is voidable under section 544, 545 or 547 of this title, a transferee or obligee of such a transfer or obligation that takes for value and in good faith has a lien on or may retain any interest transferred or may force any obligation incurred, as the case may be, to the extent that such transferee or obligee gave value to the debtor in exchange for such transfer or obligation.

STATEMENT OF THE CASE

This case concerns a bankruptcy trustee's claims to avoid transfers made to an investor in a Ponzi scheme that was operated in Colorado from the mid-1980's through 1990. The Debtor, M&L Business Machine Co., Inc. ("M&L" or the "Debtor"), a Colorado corporation, filed a voluntary Chapter 7 petition in bankruptcy on October 1, 1990. The Chapter 7 case was immediately converted to a case under Chapter 11, but on December 18, 1990, the Respondent was appointed as the Chapter 11 bankruptcy trustee in the wake of serious allegations of

fraud on the part of the Debtor's principals. After a brief investigation, the Respondent determined that the Debtor had been operating a Ponzi scheme under the guise of a business and computer equipment sales and service company. The Respondent determined that the Debtor's inventory contained over 700 boxes of dirt and/or bricks, and not computers or business equipment. (Pet. App. 47-48). The Respondent requested the Court to convert the case to a case under Chapter 7 of the Bankruptcy Code, and the conversion was ordered on October 1, 1991. The Respondent is the duly appointed and acting Chapter 7 trustee under 11 U.S.C. § 702.

In 1992 and 1993, in furtherance of her statutory duties, the Respondent commenced approximately 540 adversary proceedings to avoid transfers of money to investors under § 547(b), §§ 548(a)(1) and (a)(2) and § 549 of the Bankruptcy Code. Of the approximately 540 adversary proceedings commenced, less than ten (10) proceeded to trial. Petitioner is one of the few defendants who proceeded to trial on the merits. Approximately 300 of the 1,600 investors in M&L realized a net profit within one year pre-petition as a result of their transactions with M&L. The Respondent sought recovery of these profits. In addition, the Respondent determined during her investigation that approximately 450 of the investors in the Ponzi scheme collectively transferred to the Debtor approximately $9.0 million within the year pre-petition and never received one penny back from the Debtor. Although Petitioner lost money overall, he did not sustain the absolute losses many investors did.

Today, as a direct result of the recovery actions she commenced, the Respondent has recovered over $15.0

million, has settlements in place which will result in additional recoveries of at least $1.0 million, and anticipates administrative expenses of approximately $2.5 to $3.0 million. At this time, allowed claims are expected to range from approximately $25.0 to $30.0 million although the claims allowance procedure has not been concluded.

The Respondent also commenced recovery actions against two financial institutions through which the Debtor operated its Ponzi scheme. Neither of these financial institutions was considered an investor, like the Petitioner, in the Ponzi scheme. The two actions against the financial institutions also were settled resulting in a recovery of over $5.0 million for the benefit of creditors of M&L, which included non-investor trade creditors.

Although many of the investors in M&L claim complete ignorance of the fraudulent nature of M&L's activities, at least one has acknowledged that he ignored his own initial intuition. The court found that he was blinded by the promise of exorbitant returns and substantial profits, and plunged headlong into the scam. *Jobin v. Lalan*, 160 B.R. 851, 858-859 (Bankr.D.Colo. 1993), *aff'd*, 167 B.R. 219 (D.Colo. 1994). At trial in this case, one witness testified on behalf of the Respondent that he declined two solicitations to invest in M&L because he believed the interest rates promised could not be real and that something had to be wrong. (Pet. App. 34).

Some investors did realize net profits which were substantial, at the expense of other investors, which is that nature of a Ponzi scheme. In *Jobin v. Ripley*, 198 B.R. 800 (D.Colo. 1996), cited by the Petitioner, (Pet. App. 9-10), the defendant realized a net profit of approximately

$78,000, and at the time M&L filed for bankruptcy, had made investments in M&L for which he was promised returns of 10% per week, or 520% annualized. The Bankruptcy Court, based on the evidence presented during a four-day trial, found the Defendant Ripley had reason to know of the fraudulent purpose of M&L, and did not act with good faith with respect to his transfers with M&L.

With respect to the Petitioner's case, the Respondent and Petitioner filed cross motions for summary judgment in the Bankruptcy Court, and on or about May 5, 1993, the Bankruptcy Court granted summary judgment in favor of the Respondent on the claims asserted under § 547(b) and § 548(a)(1). In his Motion for Summary Judgment, the Petitioner argued, without substantiation, that the Debtor's payments to him were completely protected by § 547(c)(2). The Bankruptcy Court disagreed, and found that the Petitioner had not provided any evidence whatsoever, to meet the requirements of the "ordinary course of business" exception contained in § 547(c)(2) (Pet. App. 13). Moreover, the Bankruptcy Court specifically and expressly declined to hold that the "ordinary course of business" exception does not apply, as a matter of law, to transfers in furtherance of a Ponzi scheme. Instead, the Bankruptcy Court applied the undisputed and material facts, which were presented by both Petitioner and Respondent in support of their respective motions for summary judgment, to the law under an appropriate summary judgment standard. (Pet. App. 4-13). Judgment under § 547(b) was entered in the amount of $22,000.00 in favor of the Respondent after the court allowed credit in the amount of $21,500.00 for subsequent advances under § 547(c)(4).

On appeal, the District Court declined to set aside the Bankruptcy Court's factual findings that § 547(c)(2) was not available as a defense to the Trustee's claims. The District Court found that because a determination under 11 U.S.C. § 547(c)(2) is a "peculiarly factual one", due deference should be given to the Bankruptcy Court's factual findings which were not clearly erroneous. (Pet. App. 57).

While this case was pending before the Tenth Circuit Court of Appeals and before an opinion was issued in this case on May 29, 1996, the Tenth Circuit Court of Appeals ruled in another case, unrelated but also involving a bankruptcy trustee's claims to avoid transfers to investors in another Ponzi scheme, that § 547(c)(2) is not available as a defense to investors in a Ponzi scheme. *Sender v. Hegglund Family Trust*, 48 F.3d 470 (CA10 1995). Notwithstanding its ruling in *Sender v. Hegglund Family Trust*, 48 F.3d 470 (CA10 1995), the Tenth Circuit Court of Appeals reviewed the *factual findings* of the Bankruptcy Court that the Respondent's transactions with M&L were not made according to ordinary business terms. Finding that these factual findings were not clearly erroneous, the Tenth Circuit concluded that the lower courts had properly rejected the ordinary course of business defense to the Respondent's § 547 claim. (Pet. App. 87-90). The Tenth Circuit also stated an additional reason to reject the defense, that being that the § 547(c)(2) defense is inapplicable to investors in a Ponzi scheme, citing its earlier opinion in *Sender v. Hegglund Family Trust*.

Unlike numerous other Ponzi schemes which have been operated through investment and brokerage houses,

such as the Hedged Investment scheme in *Sender v. Heglund Family Trust, supra,* the M&L Ponzi scheme promised and paid outrageous returns to the investors. In general, the promised returns in M&L ranged from 10% per month to 10% per week. In addition, M&L utilized unlicensed, and in large part, untrained brokers who received commissions on the monies they brought into M&L through additional investors. M&L utilized post-dated checks and in many instances, when checks to investors bounced, M&L and/or its brokers requested the investors to hold their checks for a number of days after the date on the check before presenting them for payment. The investors complied with these requests. *Jobin v. Lalan,* 160 B.R. 851, at 859.

With respect to the Petitioner's transactions with M&L, he invested a total of $207,500.00 in M&L from June through September, 1990. He made an initial investment of $100,000.00 on June 19, 1990, receiving post-dated checks and an unsecured promissory note offering a return of 10% per month over a two-year period. A week later, he invested an additional $7,500.00 on the same terms. Later, on September 7, 1990, and again on September 10, 1990, the Petitioner invested $50,000.00 in M&L, for a total of $100,000.00. With respect to the latter two investments, the Petitioner was promised a return of 9% per week ($4,000.00), which corresponds to 468% per annum for each of the two investments. The Petitioner received post-dated checks on all of his investments. The first check the Petitioner tried to negotiate from M&L was returned for insufficient funds (Pet. App. 33). Thereafter, the Petitioner was instructed by his broker, the long-time acquaintance who introduced him to M&L, to hold his

checks for a period of five days after the date indicated on the checks before trying to negotiate them. (Pet. App. 33). The Petitioner did as he was instructed.

The Petitioner's due diligence prior to investing in M&L consisted essentially only of the recommendation of his friend and broker, and review of a four-page document titled "1989 3rd and 4th Quarter Participation Programs". Two of the four pages of the document were cover pages, and the other two were duplicates of each other and contained no information about M&L of any value to a prospective investor. (Pet. App. 32). With respect to the § 548(a)(1) claim only, the Bankruptcy Court applied an objective standard to determine what the Petitioner knew or should have known, had he done a diligent inquiry, given all the facts and circumstances of his investments in M&L. The Circuit Court's affirmance of application of an objective standard was well-reasoned, and took into consideration the cases relied upon by the Petitioner. In rejecting the Petitioner's reliance on *Merrill v. Abbott (In re Independent Clearing House Co.)*, 77 B.R. 843, 862 (Utah 1982), the Circuit Court reasoned that a determination of good faith requires a review of evidence concerning whether the presence of any circumstances placing the transferee on inquiry as to the financial condition of the transferor may be a contributing factor in depriving the former of any claim to good faith, unless investigation actually disclosed no reason to suspect financial embarrassment. (Pet. App. 53). This inquiry must be made irrespective of the test chosen. Then, based on the evidence in the record, the Circuit Court affirmed the lower Court's factual findings with respect to the § 548(a)(1) claim only and the § 548(c) defense.

REASONS FOR DENYING THE WRIT

I. THE PETITIONER SEEKS REVIEW OF A FACTUAL FINDING THAT HE FAILED TO MEET THE REQUIREMENTS OF THE ORDINARY COURSE OF BUSINESS EXCEPTION SET FORTH IN § 547(c)(2).

Contrary to the contentions of the Petitioner, the vitality of *Cunningham v. Brown*, 265 U.S. 1, 44 S.Ct. 424, 68 L.Ed. 873 (1924) is not in question in light of the enactment of § 547(c)(2) and the rulings in this case concerning its applicability as a defense to the Respondent's preference claims. The policy of recovering preferential transfers was not undermined by the enactment of § 547(c), rather, an exception which is narrowly construed was created to encourage and preserve the terms used in normal financing relations. *Clark v. Balcor Real Estate Fin., Inc. (In re Meredith Hoffman Partners)*, 12 F.3d 1549, 1553 (10th Cir. 1993), *cert denied*, 114 S.Ct. 2677, 129 L.Ed.2d 812 (1994). There is no inconsistency between *Cunningham v. Brown* and cases decided subsequent thereto, including *Union Bank v. Wolas*, 502 U.S. 151, 112 S.Ct. 527, 116 L.Ed.2d 514 (1991). (Payments on long-term debt, as well as short-term debt, may qualify for ordinary course of business exception.)

The Tenth Circuit Court of Appeals correctly left undisturbed the factual findings of the Bankruptcy Court that the Petitioner had failed to establish any evidence to meet the requirements of § 547(c)(2) and failed to establish a defense to the Respondent's preference claim. A Petition for Writ of Certiorari is rarely granted when the asserted error consists of erroneous factual findings.

Sup.Ct.R. 10. Thus, even if it were to appear that *Union Bank, supra,* and *Cunningham, supra,* are in conflict in light of the enactment of § 547(c)(2), the Petition for Certiorari should be denied because this case can be decided on another ground, that being that factual findings by a trial court which are not clearly erroneous will be left undisturbed.

Moreover, the asserted conflict, if one indeed exists, is not sufficient reason for granting review. While the Court may decide questions of public importance, it decides them in the context of meaningful litigation. Even if the Court were to examine the issue of whether § 542(c) applies to transfers in a Ponzi scheme, the Bankruptcy Court's factual findings, which have been found not to be clearly erroneous, will preclude the successful application of the defense in this case. Thus, if the Petition for Writ of Certiorari were granted, the Petitioner would still be unable to prevail on the defense set forth in § 547(c)(2), and the review by the Court would not be meaningful.

II. IT IS PREMATURE TO GRANT CERTIORARI REVIEW OF THE APPLICATION OF AN OBJECTIVE STANDARD TO THE DEFENSE OF CLAIMS TO AVOID TRANSFERS MADE WITH ACTUAL FRAUDULENT INTENT IN THE CONTEXT OF A PONZI SCHEME.

Although other Ponzi scheme bankruptcy trustees may, in fact, rely on McKay to guide them through their administration of bankruptcy estates involving Ponzi schemes, the McKay opinion rests on the particular facts of M&L and the Petitioner's transactions with M&L. Other lower courts have not yet had the opportunity to address

these factual issues in the context of other Ponzi schemes. Although the Petitioner contends that all other Ponzi schemes are similar to the M&L Ponzi scheme, and that all investors in Ponzi schemes are innocent and were defrauded out of their savings under identical circumstances, this argument, even if it were true, misses the mark.

First, not all Ponzi schemes are alike. For example, compare the Ponzi scheme operated by Hedged Investments, Ltd., which was the subject of the litigation in *Sender v. Hegglund Family Trust, supra.* In Hedged Investments, investors were promised rates of return of approximately 15%-25% per annum at a time when the market returns were also in that range. In contrast, the M&L investors were offered, during approximately the same time frame, returns ranging from 10% per month to 9% or 10% per week. These promised returns were not realistic in the market at that time. Hedged Investments, Ltd. did not issue post-dated checks. M&L did.

Second, one of the underlying policies of the Bankruptcy Code is to promote equitable treatment among all creditors of a debtor. The Petitioner's contention that all innocent and unwary investors will be harmed by the McKay opinion ignores the fact that in the M&L Ponzi scheme, approximately 450 investors gave approximately $9.0 million to M&L within the year pre-petition and received not one penny back. The McKay opinion assures investors in M&L, as well as in other Ponzi schemes, who lost all their money, that the losses will be shared on a *pro rata* basis, with other creditors, as was intended by Congress.

Third, to grant certiorari review at this time would deprive this Court of potentially valuable discussion of the issue by lower courts. *U.S. v. Mendoza*, 464 U.S. 154, 160 (1984) (This Court benefits from "permitting several courts of appeal to explore a difficult question before this Court grants certiorari."); *E. I. Du Pont de Nemours & Co. v. Train*, 430 U.S. 112, 135 n.26 (1977) (This case "exemplifies the wisdom of allowing difficult issues to mature through full consideration by the courts of appeals."); Samuel Estreicher & John Sexton, *A Managerial Theory of the Supreme Court's Responsibilities: An Empirical Study*, 59 N.Y.U. L. Rev. 681, 715-19, n.146 (1984) (describing "affirmative value" of allowing legal issues to "percolate" in lower courts before being resolved by U.S. Supreme Court).

Last, the Petitioner's characterization of the Respondent's avoidance actions constitute nothing less than the perpetuation of a Ponzi scheme is not a contention that supports granting the Petition for Writ of Certiorari.

III. THE MCKAY DECISION DOES NOT PRESENT THIS COURT WITH AN OPPORTUNITY TO SETTLE AND RESOLVE INTERPRETATIONS OF BANKRUPTCY CODE AND STATE FRAUDULENT CONVEYANCE LAW.

The Respondent agrees that following the enactment of the Bankruptcy Code in 1978, states adopted the Uniform Fraudulent Transfer Act (U.F.T.A.), and in large part, replaced the Uniform Fraudulent Conveyance Act (U.F.C.A.). As was the case in *Scholes v. Lehman*, 56 F.3d 750 (7th Cir. 1995), in this case, the U.F.T.A. was enacted in Colorado in 1992 and does not apply to the transfers

which are the subject of the Respondent's claims against the Petitioner. However, contrary to assertions of the Petitioner, even the U.F.T.A. does not insulate "good faith" transferees from fraudulent conveyance claims. The official comment to C.R.S. § 38-8-109 (1996 Cumm. Supp. Vol. 16A) (1982 Repl. Vol.) states that an insider who receives property or an obligation from an insolvent debtor, as security for or in satisfaction of an antecedent debt of the transferor or obligor, is "not a good faith transferee or obligee if the insider has reasonable cause to believe the debtor was insolvent at the time the transfer was made or the obligation was incurred." *Id.* Thus, even the U.F.T.A. applies an objective standard to determine whether a transferee has a defense to a claim concerning a fraudulent transfer.

Although courts may vary in their general approach to the questions of good faith, there are numerous reasons for this variance, the primary one being that questions of good faith necessarily involve factual determinations on a case-by-case basis. Even the court in *In re Telesphere Communications, Inc.*, 179 B.R. 544, 557 (Bankr.D.Ill. 1994), recognized that a determination of whether a transferee acted in good faith depends on the particular facts of the case and the nature of the claims asserted. The court in *In re Telesphere Communications, Inc.* was asked to determine whether a proposed settlement of avoidance claims was in the best interests of the estate. The court first determined that there was little likelihood that Telesphere, the debtor, would succeed on the actual fraud claim asserted under § 548(a)(1). Turning to the constructive fraud claims asserted under § 548(a)(2), the court found that the transferees were likely to prevail on their good faith defense, based on the particular facts of the case. The Court found

that if the debtor was acting in good faith in seeking funding, how could the lenders have acted in bad faith in supplying it? The court found the transfers in this case were made with actual intent to hinder, delay or defraud creditors. The conclusion in *In re Telesphere Communications, Inc.* makes sense and does not dictate a need to interpret fraudulent conveyance law at the Supreme Court level. The conclusion illustrates the factually intensive nature of fraudulent conveyance litigation.

Given that most courts acknowledge any determination of good faith involves consideration of the facts of the particular case, and that courts distinguish between actual fraud and constructive fraud (claims under § 548(a)(1) v. claims under § 548(a)(2)), this case does not present an opportunity to settle widespread disagreement and to determine the proper construction of § 548(c). Contrary to the contentions of the Petitioner, courts are consistent that claims involving actual fraud, and not necessarily constructive fraud, require an inquiry into whether the transferee knew or should have known of the fraudulent intent. See *Scholes v. Lehman*, 56 F.3d 750, 759 (7th Cir. 1995) and cases cited therein for the rule that a transferee is not entitled to keep any part of the property received in a conveyance that is found to have been made with actual fraudulent intent, if the transferee knew, or should have known of the fraudulent intent. In *Scholes*, the Seventh Circuit Court of Appeals applied state law to a receiver's claims to recover property transferred in a Ponzi scheme.

Even the court in *Independent Clearing House* acknowledged the test should be one that determines if there are earmarks of an arms length bargain, i.e. an objective test, as other courts have done. (Pet. App. 84-85). Significantly,

none of the cases relied upon by the Petitioner concerns an investor in a Ponzi scheme who had notice of the kind of suspicious circumstances that surrounded M&L. See also *Hayes v. Palm Seedlings Partners-A (In re Agricultural Research & Technology Group, Inc.*, 916 F.2d 528, 536 (9th Cir. 1990). (Pet. App. 76-79).

The Petitioner's contention that there is a lack of uniformity between the Bankruptcy Code and state fraudulent conveyance laws as applied to Ponzi schemes is not supported by the law and forms no basis for granting the Petition for Writ of Certiorari.

IV. THE MCKAY OPINION IS CONSISTENT IN PRINCIPLE WITH OTHER COURTS' DECISIONS

The Petitioner's contention that the Tenth Circuit Court of Appeals' decision conflicts in principle with other decisions is based on his failure to distinguish between claims based on actual fraud versus constructive fraud. The Bankruptcy Court applied an objective standard to determine whether the Petitioner acted in good faith with respect to transfers made with actual intent to defraud. The cases upon which the Petitioner relies involved claims based on constructive fraud with respect to which the trustee was limited to recovering actual profit realized over and above the return of the investor's original undertaking. Even in this case, the Bankruptcy Court acknowledged and applied the rule that an investor involved in the Ponzi scheme holds a claim for recision and restitution of his original undertaking and that only net profits realized are subject to recovery under a trustee's claim brought under § 548(a)(2). The Petitioner's

contention does not form a basis for granting the Petition for Writ of Certiorari.

Moreover, the Tenth Circuit correctly applied an objective standard and was consistent with other courts of appeal in determinations of good faith under § 548(c). (Pet. App. 76-85). The circuit courts of appeal which have addressed defenses to claims brought under § 548(a)(2) appear to have consistently applied a subjective standard in determining whether a transferee gave reasonably equivalent value and/or had culpable knowledge of the fraud. However, those cases which have addressed defenses to claims brought for actual fraud under § 548(a)(1) have applied an objective standard to both questions of good faith and value. *Matter of Furniture Den, Inc.*, 12 B.R. 522 (Bankr.W.D.Mich. 1981); *In re Ford*, 98 B.R. 669 (Bankr.D.Vt. 1989).

While this case may involve questions that affect the public at large because it is human nature for people to be drawn to investments that promise great returns that are probably too good to be true, this Court's function is not to grant certiorari to protect investors from themselves. Courts have drawn a distinction between actual fraud and constructive fraud and correctly applied the standards to determine whether a conveyance is avoidable under the circumstances. The courts are not in conflict on these issues.

Even if the Petitioner's contention that a conflict exists is correct, the Court has had a long standing policy of letting tolerable conflicts go unaddressed until more than two courts of appeal have considered a question. Justice Brennan, Some Thoughts on the Supreme Court's Work Load, 66 Judicature 230, 233 (1933). The doctrine of

judicial restraint should be applied and the Petition for Writ of Certiorari denied.

CONCLUSION

The Respondent agrees with the Petitioner's contention that one group of investors should not bear a disproportionate share of the loss. However, in considering the importance of this case, the Petitioner would have the Court ignore the hundreds of investors in M&L who lost everything and never received a penny, and the particular facts of the M&L case. This certainly is not what the Bankruptcy Code was designed or intended to accomplish. The Bankruptcy Court, the District Court and the Tenth Circuit Court of Appeals all have correctly applied an objective standard under 11 U.S.C. § 548(c) with respect to the claim under § 548(a)(1), and correctly denied the defense set forth in 11 U.S.C. § 547(c)(2) of the Bankruptcy Code. The Petition for Writ of Certiorari should be denied.

DATED this 12th day of November, 1996.

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